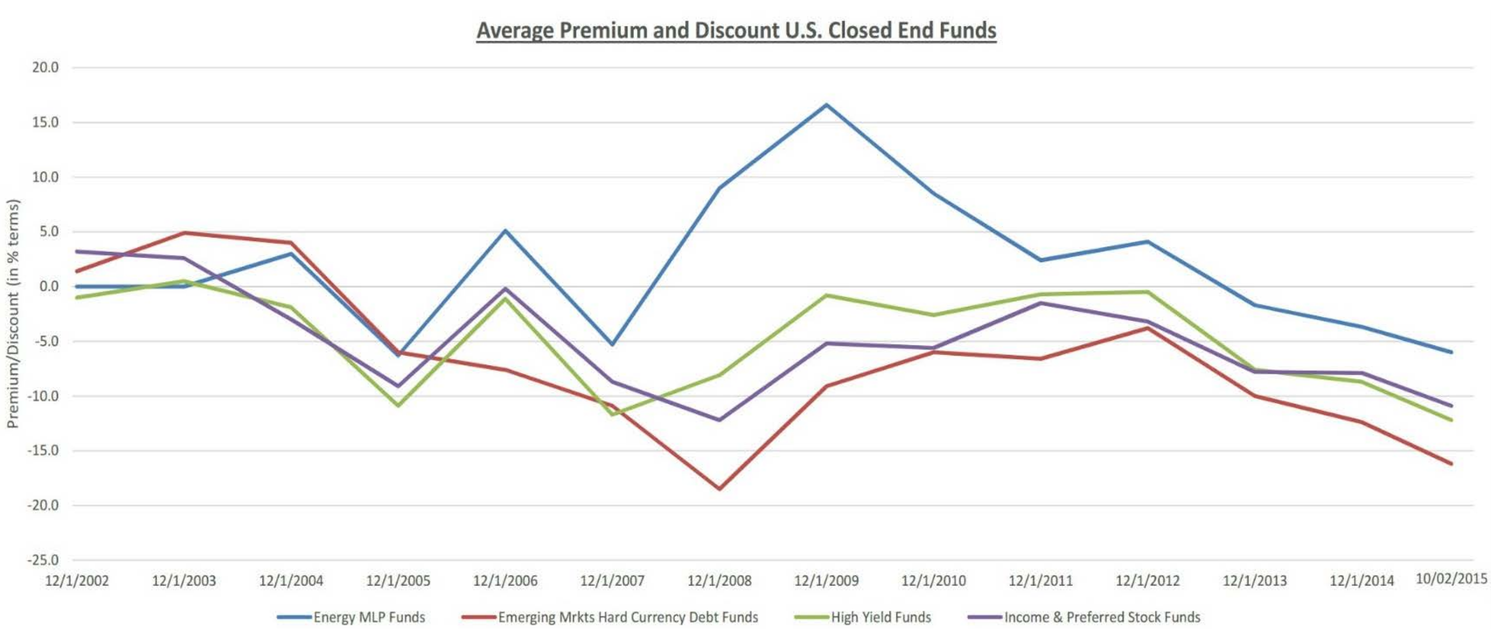
Closed End Funds: Is there an Opportunity?

Closed End Funds (CEFs) have been around for decades, but despite their lengthy existence they tend to be misunderstood and consequently are under-appreciated investment vehicles. In contrast to open end mutual funds, which have the freedom to issue unlimited shares at the fund's Net Asset Value (NAV), CEFs issue a fixed number of shares. In order to provide liquidity to current and future investors, CEFs list their stock on an exchange (e.g. NYSE). CEF shares transact at a market price, which very often differs from its NAV price. The price of a CEF may be above (premium) or below (discount) its NAV. The purpose of this paper is to discuss the merits and issues associated with CEF investments and to focus the reader's attention on the current opportunity in the space.

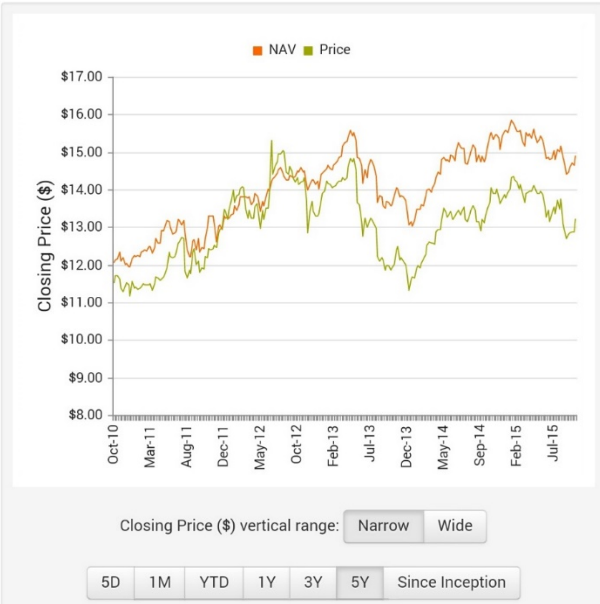
There are a few advantages to investing in CEFs, the largest being the opportunity to buy a fund at a discount to its NAV; as the discount narrows over time, the added return can be substantial. Another advantage of CEFs is that management has dedicated capital with which to invest; there is never a concern that cash will be needed to meet unexpected redemptions in times of stress. It is well documented that redemptions from panic stricken investors at market lows have hurt open end fund returns. In contrast, investing in closed end funds requires careful monitoring of discounts as they vary constantly. Another less appealing attribute is the higher expense ratios CEF tend to charge, while in addition an investor's trading costs should also be evaluated. Trading costs can be significant if the float or average daily volume is low. Lastly, since most CEFs employ leverage, the amount and costs associated with borrowing needs to be carefully considered.

At Lynx, we have been opportunistically investing in CEFs for several years. We think it is prudent in some cases to substitute closed end funds for open ended funds and vice-versa based on the attractiveness of the discounts. During the volatile months of August and September the average discount on taxable fixed income CEFs was approximately 11.5%, compared to an average discount of 4.5% over the last 20 years. The chart below provides data from the Closed End Fund Association. Based on the data, CEFs in various categories are trading at their deepest discounts. A few examples of opportunities today follow, but we caution readers to discuss the associated risks with their financial advisors prior to investment. The first example is a CEF of preferred stocks, John Hancock Premium Dividend Fund (Ticker: PDT). Unlike most preferred stock funds, the John Hancock team's specialty is utility companies. As of October 11, 2015, the fund had a distribution yield 8.2%, was 33.5% levered and traded at an 11.3% discount (PDT Premium/Discount chart). Another example is the Blackrock Corp High Yield Fund (Ticker: HYT). This fund is actively managed by the Blackrock team and invests in high yield bonds and bank loans. As of October 11, 2015, HYT was trading at a 13.7% discount (HYT Premium/Discount chart) and had a distribution yield of 8.2%, with 30% leverage.

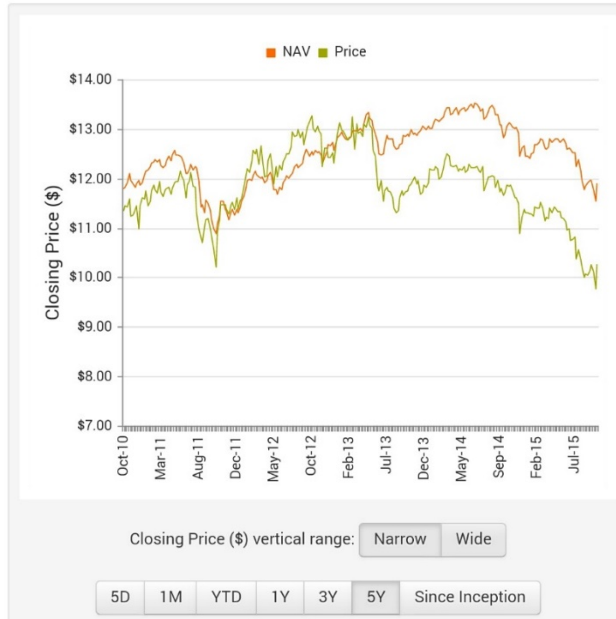


*Data: Lipper, A Thomson Reuters Company; Chart: Lynx Investment Advisory

PDT Discount/Premium Over 5 Years



HYT Premium/Discount Over 5 Years



* Charts: CEFConnect.com

In summary, CEFs have their merits and limitations. At times, CEFs can be bought for deep discounts that ultimately can boost investor returns. In our opinion, the current environment is offering many closed end funds at record discounts. Therefore, in our opinion, many CEFs offer a compelling opportunity in the current market environment.